



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

November 21, 2002

MEMORANDUM FOR ACTING COMMISSIONER WENZEL

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Office of Audit Comments Concerning Management's
Response to the Audit Report *The Internal Revenue Service
Needs to Simplify Filing Requirements and Clarify Processing
Procedures for Small Business Corporation Returns*
(Audit # 200130037)

This memorandum presents our concerns with the Internal Revenue Service's (IRS) management response to the subject report. The response to the report was received after the final report was released.

In their response, management stated, "We do not believe you sampled enough cases from the two campuses now processing cases to reliably estimate the impact of taxpayer burden or potential loss *[sic]* revenue. Additionally, the information from the other eight campuses has significantly skewed the data."

We believe that our sampling methodology accurately presents the issues in the report and the burden to taxpayers. The issue regarding the legal requirements and the IRS' burdensome process, which is hampering first-time filers from filing their small business returns, is systemic in nature. Systemic issues would exist in all locations, regardless of where the work is being performed. Also, during our review, we noted that the Ogden and Cincinnati Campuses were inconsistently handling the unprocessable U.S. Income Tax Returns for an S Corporation (Form 1120S). Since there are only 2 campuses now performing the function that 10 campuses originally performed, the impact of the inconsistent handling of these taxpayers and the related burden and lost revenue could be greater, rather than less, than we reported.

In management's response to our four recommendations, we believe that corrective actions are not as expeditious as they should be to relieve the taxpayer burden. In addition, one of the corrective actions is not sufficient. The recommendations from our report, management's response, and Office of Audit comments follow:

Recommendation 1: The Director, Compliance, Small Business/Self-Employed (SB/SE) Division, should simplify the process of filing election forms and Forms 1120S

for new filers by determining if there are alternatives to make it easier for first-time filers to be granted elections and file their Forms 1120S, and by considering implementing alternatives and seeking modification of the legal requirements, as necessary.

Recommendation 2: The Directors of Customer Account Services and Compliance, SB/SE Division, should develop procedures that would improve and simplify both the process for approving, recording, and controlling elections and the related notification process to make it easier for taxpayers to file their Forms 1120S.

Management's Response: Reporting Compliance has formed a task force to study and resolve the causes¹ identified. The team held their first meeting on September 12, 2002. A second session was held on October 2 and 3, 2002. Team members included analysts from Reporting Compliance and from Business Master File Policies, Procedures, and Guidance Branch, as well as field employees from Reporting Compliance and Submission Processing Centers. The overall scope of the team's efforts included the study of the Election by a Small Business Corporation (Form 2553) election process, including delinquent elections, as well as the process for converting invalid Forms 1120S to Forms 1120. The IRS' response indicates that these actions will be completed by January 1, 2004.

Office of Audit Comment: For Recommendations 1 and 2, we believe that the corrective actions are sufficient to correct the problems we reported, but these actions should be taken sooner. Determining whether legal requirements need to be changed and developing alternatives to make it easier for first-time filers to be granted elections may be somewhat time-consuming to accomplish. However, we believe that waiting until January 1, 2004, approximately 14 months from the date of the response, for these corrective actions to be implemented is not as expeditious as it should be to relieve the taxpayer burden.

Recommendation 3: The Director, Compliance, SB/SE Division, should establish procedures for ensuring that IRS records accurately reflect the filing of Forms 1120S once the IRS subsequently verifies that an election was granted. Specific procedures should be developed for converting the Forms 1120 back to the originally intended Forms 1120S.

Management's Response: The IRS does not see a need to make a correction to indicate that the original filing was a Form 1120S. By correcting the records to indicate that a valid election existed for that period, it believes it has essentially established that the filing requirement was met. The actual document is the record of the taxpayer's intent. However, the task force (see Recommendations 1 and 2) will look at this issue further to determine if any alternatives exist. The IRS' response indicates that these actions will be completed by January 1, 2004.

Office of Audit Comment: Corrective actions are needed to ensure the accurate filings of small business corporate tax returns. The IRS should prescribe specific

¹ The Assessment of Cause in management's response stated that, "We have not developed clear and consistent guidelines for processing the Form 1120S when delinquent elections are received. Taxpayers are subject to inconsistent treatment when invalid 1120S returns are converted to Form 1120."

procedures for correcting taxpayers' records for the tax year being filed to show the filing of Forms 1120S. The correction of a record to show that a valid election exists for that period corrects the Entity Section of the taxpayer's account. However, it does not automatically ensure that any assessments made on gains, as well as related interest and penalties, are abated. It also does not ensure that the tax account for the tax period accurately reflects the filing of a Form 1120S. If these procedures are not revised or developed, the IRS' records will not accurately reflect the filings of Forms 1120S for some first-time filers. Also, we believe that corrective actions need to be implemented sooner than January 1, 2004, to maximize benefits to small business taxpayers.

Recommendation 4: The Director, Compliance, SB/SE Division, should clarify Internal Revenue Manual procedures and assign responsibility for determining and assessing the correct taxes and issuing statutory notices of deficiency for small business corporate returns that could not be processed because the IRS could not verify that valid elections were filed.

Management's Response: The team will work with Chief Counsel to determine the proper way to assess taxes on small business corporate returns that the IRS could not process. After the IRS resolves this issue, it will update the appropriate Internal Revenue Manual procedures. The IRS' response indicates that these actions will be completed by January 1, 2004.

Office of Audit Comment: We believe that the implementation date for these corrective actions should be sooner than January 1, 2004. Fourteen months appears to be an unreasonably long time in which to obtain the Chief Counsel's opinion and to make changes to current procedures, where necessary.

While we have some concerns with the timeliness and adequacy of the corrective actions, we do not intend to elevate our concerns to the Department of the Treasury for resolution. Consequently, no further action on your part is required.

Copies of this memorandum are also being sent to the IRS managers who received a copy of the final report. Please contact me at (202) 622-6510 if you have questions, or your staff may call Parker F. Pearson, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (410) 962-9637.

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